

Information from the Division of Health Care Finance and Policy

# FY03 Annual Acute Hospital Financial Report

*Overall, profitability in FY03 continued to improve, but remained an issue for over a third of the industry. Liquidity remained fairly stable, with most hospitals still comfortably able to meet short-term obligations. Long-term solvency continued to deteriorate, with just over a third of the industry falling below benchmarks for Debt Service Coverage and Equity Financing.*

## About this Report

The Division of Health Care Finance and Policy (the Division) publishes an acute hospital financial report yearly in response to a legislative mandate to provide an annual assessment of financial trends in the acute hospital industry. The annual report is one part of the Division's ongoing program to better protect the public interest by continuously monitoring the financial condition of acute hospitals. This report presents analysis of FY03 hospital data that has been reconciled to the hospital's audited financial statements,<sup>1</sup> and supersedes the Division's Quarterly Acute Hospital Financial Report for FY03 Q4, which was published on this web site in January 2004. On an aggregate basis, the findings have not changed dramatically since the FY03 Q4 posting. However, values for some individual hospitals have changed significantly as a result of their audit process and year-end adjustments.

Financial trends for individual hospitals are on each hospital's Fact Sheet at [www.mass.gov/dhcfp](http://www.mass.gov/dhcfp). Trends in financial ratio analysis can provide useful information about the hospital industry's financial condition. The three areas discussed in this report are profitability, liquidity, and solvency.<sup>2</sup>

## Profitability

While the Massachusetts acute care hospital industry is 94% non-profit, these hospitals need to generate a surplus in order to continue to complete their mission, repay debt, and invest in the future of their organizations. Therefore, three profitability ratios are reported here: Operating Margin, Non-operating Margin, and Total Margin. Figures 1, 2, and 3 on page 2 show FY99-FY03 trends for 25th, 50th (median) and 75th quartile values<sup>3</sup> for Operating Margin,<sup>4</sup> Non-operating Margin,<sup>5</sup> and Total Margin.<sup>6</sup>

Overall, industry profitability improved in FY03. Total Margins improved across the industry, with a 4% decrease in the number of hospitals reporting overall losses. Non-operating performance appears to have stabilized after a steady three-year slide, with less than 15% of all hospitals showing non-operating losses. Median Operating Margin was positive for the second straight year. However, it is important to note

<sup>1</sup> This report is based on 12 months of FY03 desk audited data for 64 acute hospitals and 12 months of unaudited data for three acute hospitals. Data for all of the former hospitals have been reconciled to the audited financials.

<sup>2</sup> Depending on the organization of each hospital, data may exclude other aspects of some hospitals' financial health, such as performance of endowments or the financial health of parent or other affiliated organizations.

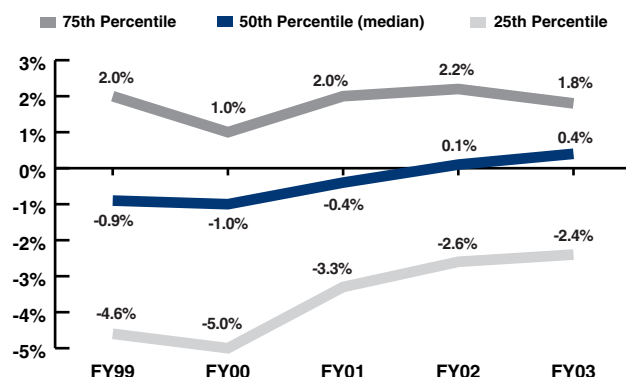
<sup>3</sup> Quartile values can shed light on information about the distribution of financial ratio values across hospitals. Often, averages can be materially affected by outlier/extreme values at the low and high ends of a distribution. Examining quartiles, therefore, is a preferred means of assessing the overall distribution of values across hospitals. For instance, the ratio values of one quarter of the hospitals at the low end of the distribution will fall at or below the 25th quartile value. Similarly, the ratio values of one quarter of the hospitals at the high end of the distribution will fall at or above the 75th quartile value. The 50th percentile is the median, or the center of the distribution of values. Half of the hospitals' financial ratio values will fall below the median, and half will fall above the median. These quartile measures are particularly useful when a distribution is markedly skewed, or where it is generally symmetrical but includes a few extreme values at one end (outliers).

<sup>4</sup> Ratio of operating income to total revenue.

<sup>5</sup> Ratio of non-operating income to total revenue.

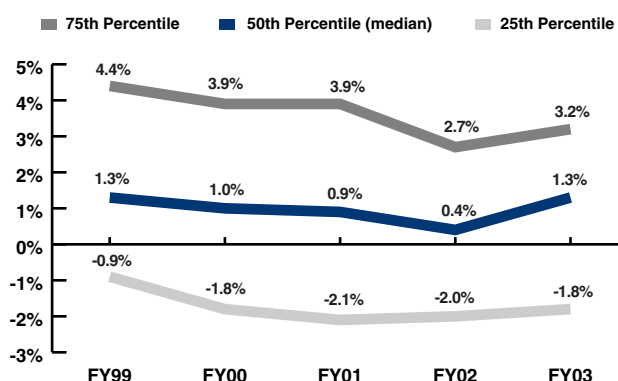
<sup>6</sup> Ratio of total income to total revenue.

**Figure 1**  
**Operating Margin Trend, FY99-FY03**



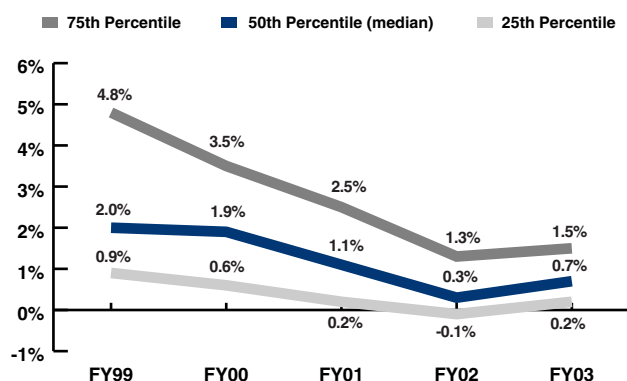
- Median Operating Margin improved and was positive for the second straight year. A high, though slightly declining, percentage of hospitals continued to have operating losses (46%).

**Figure 3**  
**Total Margin Trend, FY99-FY03**



- Total Margins improved across all quartiles; however, over a third of the industry continued to have overall losses (36%).

**Figure 2**  
**Non-operating Margin Trend, FY99-FY03**



- Fueled by improved investment performance, Non-operating Margins stabilized after a steady three-year slide across all quartiles. The percentage of hospitals with non-operating losses decreased by half since FY02.

that a significant (but declining) number of hospitals continued to have operating losses (46% in FY03 compared to 53% in FY01).

## Liquidity

Liquidity ratios indicate hospitals' ability to meet their short-term debt obligations. Deterioration of these ratios is one indication of financial problems. Three liquidity ratios are reported here: Current Ratio,<sup>7</sup> Average Days in Accounts Receivable,<sup>8</sup> and Average Payment Period.<sup>9</sup> Figures 4, 5, and 6 show trends in quartile values for these three ratios. Current Ratio, a measure of hospitals' ability to meet short-term obligations, has been fairly stable since FY99 with most of the industry performing above the 1.0 benchmark (see Figure 4).<sup>10</sup> Average Days in Accounts Receivable, the average length of time it takes hospitals to receive payment, remained stable in the median and lower quartiles at 52 and 44 days respectively, while the upper quartile improved by five days (see Figure 5).

<sup>7</sup> Ratio of current assets to current liabilities.

<sup>8</sup> Ratio of net patient accounts receivable to net patient service revenue/365.

<sup>9</sup> Ratio of current liabilities less estimated third-party settlements to total expenses less depreciation and amortization/365.

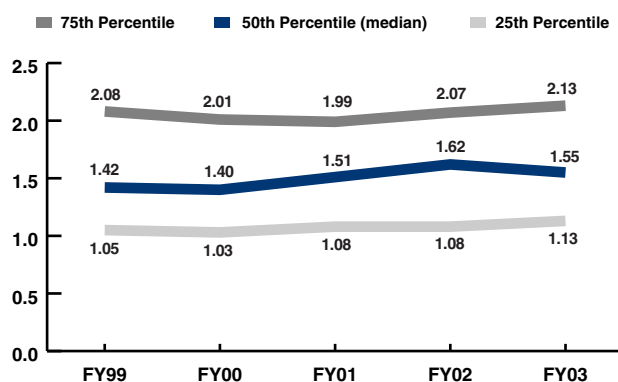
<sup>10</sup> A Current Ratio value of 1.0 indicates that a hospital can cover all its current liabilities with its current assets. Values below 1.0 are considered unfavorable.

The industry has shown steady improvement in this measure over the last five years. The average time it took hospitals to pay bills (Average Payment Period) worsened by five days in the upper quartile, but otherwise remained flat at 54 days in the median quartile and 45 days in the lower quartile (see Figure 6).

## Solvency

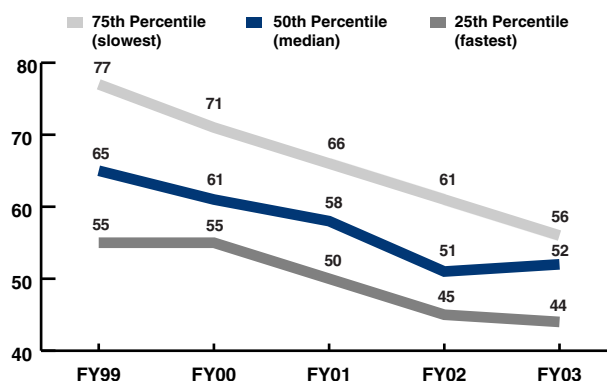
Solvency ratios provide information regarding both how an organization finances its assets and how able an organization is to take on new debt. Deterioration of these ratios is one indication of problems in the financial health of an organization. Three solvency ratios are reported here: Cash Flow to Total Debt,<sup>11</sup> Debt Service Coverage,<sup>12</sup> and Equity Financing.<sup>13</sup> Cash Flow to Total Debt Ratio measures hospitals' ability to meet both their current liabilities and their long-term debt with funds from all sources. Cash Flow to Total Debt declined across the industry, continuing a five-year downward trend. Debt Service Coverage, a measure of whether hospitals can

**Figure 4**  
**Current Ratio Trend, FY99-FY03**



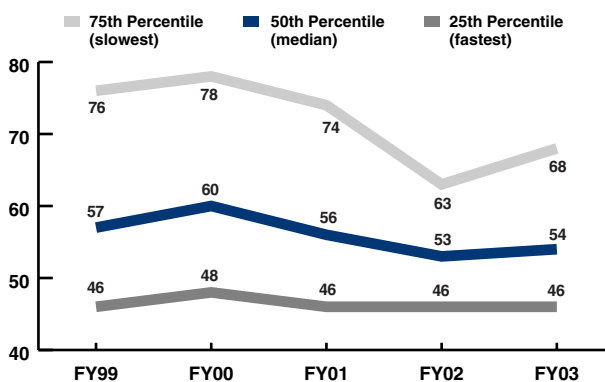
- Current Ratio remained relatively stable across the industry. Most hospitals' Current Ratios were above the 1.0 benchmark (82%).

**Figure 5**  
**Days in Accounts Receivable Trend, FY99-FY03**



- Average Days in Accounts Receivable remained fairly stable with the exception of the upper quartile which improved by five days. The upper quartile consistently improved since FY99 by an average of 5 days a year.

**Figure 6**  
**Average Payment Period Trend in Days, FY99-FY03**



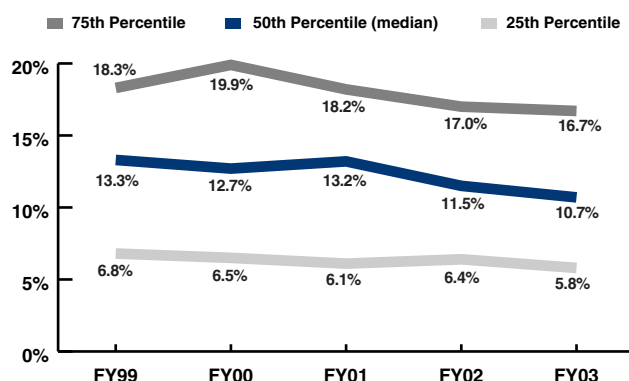
- Median Average Payment Period remained flat, while the upper quartile worsened by five days.

<sup>11</sup> Ratio of total income plus depreciation and amortization to total current liabilities plus total long-term debt.

<sup>12</sup> Ratio of total income plus interest expense plus depreciation and amortization to interest expense and current portion of long-term debt.

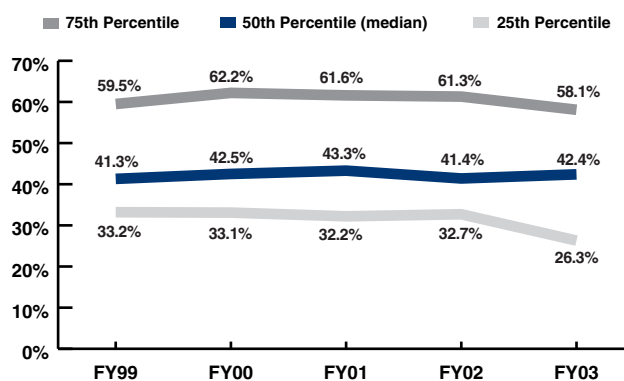
<sup>13</sup> Ratio of total net assets to total assets.

**Figure 7**  
**Cash Flow to Total Debt Trend, FY99-FY03**



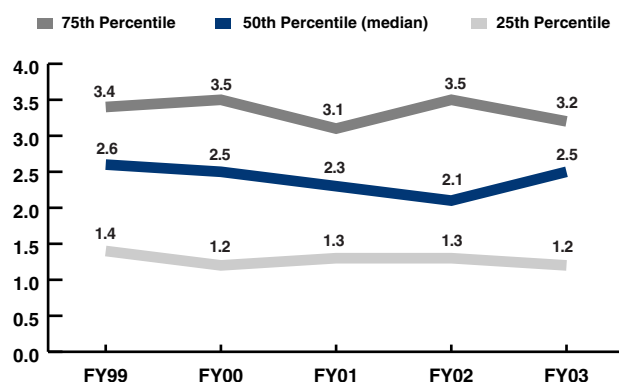
- Cash Flow to Total Debt Ratio declined across the industry over the past five years, indicating a worsening of hospitals' long-term solvency.

**Figure 9**  
**Equity Financing Trend, FY99-FY03**



- Equity Financing Ratios worsened in FY03. Almost a third of hospitals were below the 30% benchmark, indicating that these hospitals may find it difficult to finance future asset acquisition.

**Figure 8**  
**Debt Service Coverage Total Trend, FY99-FY03**



- Although median Debt Service Coverage remained comfortably above the 1.5 benchmark, 39% of hospitals' Debt Service Coverage Total Ratios fell below 1.5, indicating that these hospitals may have trouble repaying their debt.

meet their principal and interest payments only, was inconsistent across the industry, with the upper and lower quartiles declining and the median slightly increasing. While the median remains comfortably above the 1.5 benchmark, over a third of hospitals fall below, predominantly due to overall losses driven by operations.<sup>14</sup> Equity Financing reflects the ability of a hospital to take on more debt and is measured by the proportion of total assets financed by equity. Low values indicate that a hospital has used substantial debt financing to fund asset acquisition, and therefore may have difficulty taking on more debt to finance further asset acquisition. Equity Financing showed some deterioration, with both the upper and lower quartiles declining. The poorest-performing quartile fell below the industry benchmark of 30% for the first time in five years.

### Teaching versus Non-teaching Hospitals

The Division examines financial ratios across all quartiles according to teaching versus non-teaching status, to isolate

<sup>14</sup> William O. Cleverly, *Essentials of Health Finance*, Fourth Edition, Copyright © 1997 by Aspen Publishers, Inc.

significant trends occurring in these categories. The performance of 16 teaching hospitals and 51 non-teaching hospitals was analyzed; along financial measures, little difference was found between the two groups with two exceptions. First, although teaching hospitals' Median Total Margins were slightly less than non-teaching hospitals' Median Total Margins, a lower percentage of teaching hospitals had overall losses. Second, teaching hospitals demonstrated stronger solvency than non-teaching hospitals in all performance measures. For example, a lower percentage of teaching hospitals' Debt Service Coverage and Equity Financing Ratios fell below industry benchmarks.

## Summary

Profitability continued to improve industry-wide, but remained an issue for over a third of the industry. Median Operating Margin was positive for the second straight year, and Non-operating Margins stabilized as the result of improved

financial market conditions. Total Margins improved for the industry as a whole, though 36% of hospitals continued to struggle with overall losses. Liquidity, as measured by the Current Ratio, remained fairly stable with most hospitals sufficiently able to meet short-term obligations. Payment and Receivable measures remained flat, with the exception of the upper quartile which improved in payment time and worsened in collection time. Long-term solvency is a serious concern: Cash Flow to Total Debt continued a five-year decline, a third of the industry fell below the benchmark in Equity Financing, and almost 40% of the industry fell below the benchmark in Debt Service Coverage.

Financial ratio values for each hospital are on the Hospital Fact Sheets at [www.mass.gov/dhcfp](http://www.mass.gov/dhcfp). Hospital-specific dollar surplus or loss, net patient service revenue, total net assets, and assets whose use is limited are also provided on the Hospital Fact Sheets illustrating the magnitude of hospital surplus and loss, the size of operation, and the size of reserves.